IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX REFERENCE No 351 of 1983

For Approval and Signature:

Hon'ble MR.JUSTICE R.K.ABICHANDANI and
MR.JUSTICE R.BALIA.

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1. Whether Reporters of Local Papers may be allowed to see the judgements?

2. To be referred to the Reporter or not?

3. Whether Their Lordships wish to see the fair copy of the judgement?

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder?

5. Whether it is to be circulated to the Civil Judge?

COMMISSIONER OF INCOME TAX, BARODA

Versus

STANDARD MALTINGS & ALLIED PRODUCTS CORPORATION

Appearance:

MR. BHARAT J. SHELAT, instructed by
MR MANISH R BHATT for Petitioner
MR D.A. MEHTA, MR. R.K. PATEL & MR. B.D. KARIA
for MR KC PATEL for Respondent No. 1

CORAM : MR.JUSTICE R.K.ABICHANDANI and
MR.JUSTICE R.BALIA.

Date of decision: 10/01/97

ORAL JUDGEMENT(Per R.K.Abichandani,J.)

The Income Tax Appellate Tribunal, Ahmedabad Bench "C" has referred the following question for the opinion of this Court, under Section 256(1) of the Income Tax Act, 1961.

"Whether on the facts and in the circumstances of the case the Tribunal was right in law in coming to the conclusion that the sum of Rs.2,50,348/- paid by the assessee to its retiring partners was an allowable expenditure under Section 37 of the Income Tax Act, 1961?"

The matter relates to the assessment year 1975-76. The assessee which was assessed in the status of un-registered firm, was engaged in the business of manufacturing malt for Brewery Units. The assessee filed its return of income on 5th April, 1976, declaring a loss of income of Rs. 2,10,595/-. As the proposed variation in the returned loss turned out to be more than Rs. 1 lac, a draft order under Section 144B was served on the assessee on 30th March, 1978, to which the assessee filed its objections as regards the additions proposed. The assessee firm had charged the Profit and Loss Account, an amount of Rs. 2,50,350/- as the expenditure incurred in the name of compensation to retiring partners with the following breakup:-

1. Smt. R.V. Mehta :Rs. 98,250/-
2. Miss D.B.Mehta :Rs. 48,375/-
3. Shri P.V.Mehta :Rs.1,02,725/-

According to the assessee this expenditure was admissible as an expense of business under Section 37 of the said Act, because the above erstwhile partners belonging to the group of the Partner Mr. P.V.Mehta who did not look after the business of the assessee efficiently and due to his mis-management, the project had failed, were, in the larger interest of business made to retire by giving the above payments to them. The I.A.C.B.R.I, Baroda held that these payments were not admissible as business expenditure because they were made by one group of proprietors to the other for the purchase of the proprietory rights in the business. The ITO by order dated 29th June, 1978 accordingly disallowed the said expenditure of Rs. 2,50,350/- claimed by way of compensation to the retiring partners. Against that order the assessee approached the Commissioner of Income Tax (Appeals) raising the same contentions which did not find favour with the CIT, who held that the payments to the retiring partners were made to acquire their rights in the business of the firm and therefore, such payments were not deductible in the assessment of the firm. Thereupon, the assessee approached the Tribunal. The

Tribunal while accepting the proposition that if payment of compensation was towards settlement of amounts between the partners for acquiring the rights of the outgoing partners such payments would not be deductible under Section 37 as they would amount to expenditure of capital nature, came to the conclusion that since the firm was under huge losses nothing was payable to the outgoing partners towards their capital in the firm and therefore, the compensation paid by the continuing partners was essentially an expenditure incurred in course of business and for the purpose of business. The Tribunal held that the approach of the lower authorities, which was to the contrary, was not correct because the expenditure was incurred in order to facilitate carrying on of business by removing the inefficient partners whose continuance would have caused further damage to the business. The payment was, according to the Tribunal, made in order to get rid of the disadvantageous relationship at the behest of or on the recommendation of the bankers and the payment of compensation which was made in order to remove the disadvantage cannot be equated with an enduring benefit. The Tribunal however, observed that it was not laying down a general proposition to the effect that in every case of retirement of a partner such compensation would be an expedient expenditure allowable on revenue account. The Tribunal holding that the said amount of compensation paid to the retiring partners was allowable deduction on the revenue account, allowed the assessee's appeal.

The learned Counsel appearing for the Revenue contended that the expenditure incurred for acquiring the rights of the retiring partners in the assets of the firm was not revenue expenditure. He submitted that such expenditure cannot be said to have been incurred for the purposes of running the business. Referring to the deed of retirement, he submitted that it was clear that the payments made to the retiring partners, which are described as compensation, were in fact payments made in lieu of the rights of the retiring partners and there was nothing in the deed to suggest that the payments were made for the purpose of running the business. The learned Counsel further argued that getting rid of an inconvenient and inefficient employee or an agent in the interest of the business of the firm was entirely a different matter from making payment to the retiring partners of the firm in lieu of their rights in the firm.

The learned Counsel appearing for the assessee submitted that the expenses were incurred by the firm for efficient running of its business because the management

of Mr. P.V.Mehta, who was a partner, resulted in losses and the only way in which the business could be run profitably was to make his group retire. It was submitted that the firm had incurred huge losses and nothing was payable to the outgoing partners on their account and therefore, the expenses incurred by the firm should necessarily be treated as expenses incurred on the revenue account. It was further contended that a partnership firm was a distinct taxable entity and is treated distinctly regardless of its position under the Partnership law. Therefore, according to him a firm which is being assessed as an independent unit under the Income Tax law should be viewed as a distinct entity from its components. He submitted that the terms of the retirement deed were not relevant to ascertain the real nature of the expenditure incurred by the assessee firm and that the Court should not view the situation in context of the Partnership Act. He therefore, supported the reasoning of the Tribunal.

It is difficult to accept the contention raised on behalf of the assessee that a firm which is assessed as an independent taxable entity for the purpose of assessment should not be viewed in context of the provisions of the Partnership Act. Retirement of a partner from a firm is a factor which has a bearing on the constitution of the firm. Even the scheme under the Income Tax Act regarding assessment of firm as a distinct assessable unit does not do away with the concept of partnership and rights and duties of Partners inter-se continue to be governed by the provisions of the Indian Partnership Act. Though, for the purpose of taxation a `firm' is treated as a distinct unit, its meaning even in the context of the Income Tax Act remains the same as is assigned in the Indian Partnership Act. Section 2(23) of the said Act provides that the expression "firm", "partner" and "partnership" has the meanings respectively assigned to them in the Indian Partnership Act, 1932, but the expression "partner" shall also include any person who, being a minor, has been admitted to the benefits of partnership. Separate provisions are made for assessment of the firms in Chapter XVI of the said Act, which interalia require application for registration of the firm to be signed by all the partners. Such application is to be made before the end of the previous year for the assessment year in respect of which the registration is sought. The registration is for the assessment year and by virtue of sub-section (7) of Section 184 of the said Act, enures for subsequent assessment years, provided no change is made in the constitution of the firm or the shares of the partners. Where change is made in the

constitution of the firm, a fresh application for registration is required to be made for the reconstituted firm. These provisions show that a registered firm is treated as an assessable unit only for the years during which its composition remains unchanged and on change the reconstituted firm is to be registered afresh. Furthermore, under Section 187 of the said Act where there is a change in the constitution of the firm, the assessment is to be made on the firm as constituted at the time of making the assessment as provided therein. The provisions relating to assessment of firm under the said Act indicate that even the said Act recognizes the fact that by change in composition the firm gets reconstituted meaning thereby the earlier firm composed of all the existing partners ceases and a new firm is constituted as per the change which requires a fresh registration. Therefore, retirement of a partner which has the effect of changing the constitution of the firm in this context is required to be viewed in the light of the provisions of the Partnership Act, which alone deals with the question of the constitution of the firms, their reconstitution and dissolution, as also with the rights and duties of the continuing partners as well as the outgoing partners. The Income Tax Act does not contain any provision having bearing on the question of constitution of the firm. It therefore, can never be said that the provisions of the Partnership Act should be ignored the moment a firm is viewed as an independent taxable entity under the Income Tax law.

The partners are, in both commercial and legal terms, collectively referred to as a "firm" but with very different underlying perspectives. The commercial view reflected in the approach of most accountants involves treating a firm much in the same way as a company i.e. as a distinct entity from the members composing it. The law rather looks to the partners composing the firm, and, any change in their number destroys the identity of the firm. What is known as partnership property is in reality the property of the partners and the firm's debts and liabilities are their debts and liabilities. Thus, a partner can be the debtor or the creditor of his co-partners, but he cannot either be debtor or the creditor of a firm of which he himself is a partner, nor can he be employed by his firm, for he cannot employ himself. On retirement of a partner the composition of a partnership changes and results in a technical dissolution of the existing firm and creation of a new firm though it would not be a general dissolution involving full scale winding up of the business of the firm. We therefore, are unable to accept the contention

raised on behalf of the assessee that the change in the composition of the assessee firm by virtue of retirement of the Partners of Mehta Group should be viewed without reference to the provisions of the Partnership Act and the deed of retirement as also the provisions of the Partnership law relating to the outgoing partners.

In the present case the three partners of Mehta Group retired with effect from 3rd December, 1974 under a deed of retirement dated 4th December, 1974, which is at Annexure "F" in the paper book of the reference. The continuing partners were Smt. Sulochanaben Mazumdar and Smt. Yaminiben Mazumdar. Under the said deed the terms and conditions of retirement and release mutually agreed between the parties have been recorded. Accordingly, the retiring partners had retired from the firm of Messrs Standard Maltings and Allied Products Corporation with effect from the close of business on 3rd day of December, 1974 on an express understanding and agreement that the continuing partners shall be entitled to continue the business of the said partnership from 4th December, 1974 as per their absolute choice and further that they shall be entitled to use the firm name for the purpose of continuing the business of the said partnership. It was also stipulated that the continuing partners will be entitled to all the rights, title and interest of the said partnership inclusive of all quota rights, tenancy rights, import and export licences and all other benefits and privileges, as also contract rights. The continuing partners were entitled to the sole and exclusive right to endorse, collect and release all the outstandings of the firm and its claims. The retiring partners were absolved from their liabilities from the date of their retirement. Under the said deed the retiring partners relinquished all their rights, titles and interests in the assets, actions, claims, demands, benefits, privileges and good-will of the partnership and in consideration of full discharge of such rights and in full satisfaction of their claims in respect of the amounts contributed by them towards the capital of the partnership and in full satisfaction of all sums of money due to them in respect of their accounts, payments were to be made to them by the continuing partners of a total sum of Rs. 20,09,000/as specified in clauses 5 and 6, read with schedule "A" of the partnership deed. The said schedule incorporated the statements of the sums of money payable by the continuing partners to the retiring partners which included the amounts payable on account of contribution of capital, current accounts, the amounts payable under the terms of the deed for diverse considerations mentioned in the deed and an amount of compensation for a

period of nine months from the date of the deed stipulated as payment period. This arrangement was to be treated as a final settlement of the account and as stipulated in paragraph 6 of the deed, the continuing partners were not entitled to deduct anything from these amounts as and by way of shares of the retiring partners in the accumulated losses of the firm and the amounts which were debited in the accounts of the retiring partners in the books of accounts of the firm were to be treated as duly recovered in settling the amounts payable to the retiring partners. On reading the relevant terms and conditions of the deed of retirement and release, we are fully satisfied that the outgoing partners were made payments in lieu of their right, title and interest in the partnership firm including in its assets and good-will. Under the said deed, the partners had agreed to quantify the amount which was to be paid by the continuing partners to the retiring partners for enabling the continuing partners to acquire the rights and interest of the outgoing partners in the firm and for getting the exclusive right to continue the business of the firm in the firm name. When the partners had chosen to attribute a specified value to the rights of the outgoing partners which were being acquired by the continuing partners under the said deed, it was not open to any outsider to suggest that there was nothing payable in respect of the rights and interests of the outgoing partners by the continuing partners and that the outgoing partners had no interest whatsoever in the firm which could be acquired by making any payment. The case put up by the assessee that the payments were made under the deed by the continuing partners for the smooth running of the business of the firm is not at all warranted in view of the specific terms and conditions stipulated under the deed which described the payments having been made to the outgoing partners in satisfaction of their legal rights and interests in the assets and good-will of the firm. We are told that the partnership firm was a partnership at will. In that event any partner could have given a notice in writing to the other partners, of his intention to dissolve the firm as provided by Section 43 of the Partnership Act. The outgoing partners had, under Section 36 of the Partnership Act, right to carry on a business competing with that of the firm and under Section 37 they had a right in certain cases to share subsequent profits. In a partnership at will where dissolution is made by giving a notice to other partners, the partners have a right to have the business wound up after the dissolution. There are rules laid down for settlement of accounts between the partners in Section 48 of the Partnership Act. In settling the accounts of a

firm after dissolution, the good-will is to be included in the assets and can be sold either separately or with the other property of the firm. These provisions indicate that a retiring partner who otherwise had a right to participate in the business foregoes valuable rights in consideration of what is paid by the continuing partners. When the continuing partners agree to pay a quantified amount to the retiring partners without reference to the actual state of the books of account that would be a matter entirely between them and it would be open for the partners to settle the accounts as per their agreement. Thus, we are fully satisfied that the payments which were made under the deed were made in lieu of the rights of the outgoing partners by the continuing partners and there was no question of the assessee firm incurring any revenue expenditure in the matter and that these payments were in no way connected with the running of business of the firm and they were therefore, not deductible in the assessment of the assessee firm.

In the context of the view that we have taken, we must refer to the decision of the Andhra Pradesh High Court in CIT Vs. Purandas Ranchhoddas - 169 ITR 480, wherein a question arose as to whether payment made to the outgoing partners under the deed of dissolution towards the good-will was a revenue expenditure. The High Court held that though the deed of dissolution did not expressly mention that the consideration of Rs. 80,000/- received was either towards relinquishment of the rights in the good-will or the use thereof by the other partners, the true legal relationship resulting from a transaction was to be determined. On perusal of the relevant clauses of the deed it was found that there was total cessation between the relationship of the outgoing partners and the remaining partners. The Court held that it was obvious that in consideration of giving up their right, title and interest in the good-will of the firm, the retiring partners had received the good-will of Rs. 80,000/-. It was held that the fact that the consideration was not adequate was not by itself a circumstance to show that what was conveyed was not relinquishment of a pre-existing right, title and interest. The Court held that when the payment was made it was not incidental to the carrying of business, but was incidental to the reconstitution of the business by the remaining partners and the consideration was paid to acquire a capital asset and was a capital expenditure. We are in respectful agreement with this proposition laid down in Purandas Ranchhoddas (supra).

In General Auto Parts Co. . CIT reported in 128

ITR 519, a similar question arose in context of payment of amounts by the continuing partners of the firm in order to acquire the right, title and interest of the retiring partners in the assets of the former firm and the Delhi High Court took a view that, where a certain sum of money is paid by the continuing partners of a firm in order to acquire the right , title and interest of the retiring partners in the assets of the firm the payment made cannot be said to be incidental to the carrying on of the business that is incidental to a reconstitution of the framework of the business itself.

The cases of relationship between the partners and the firm cannot be equated with the relationship that may exist between a company and its employees or managing agents. A payment made by a company to its Directors or managing agents would be a payment made by a distinct legal entity while a firm not being a distinct legal entity separate from its partner, payment made to the outgoing partners was clearly a payment of capital nature relatable to the settlement of accounts between the partners inter-se. The payment which was made by the continuing partners to the retiring partners was clearly relatable to the ownership of the business and towards settlement of mutual rights as owners and not as traders. By relinquishment of the shares of the retiring partners, there was a corresponding increase in the shares of the continuing partners in the firm. Such a situation cannot be equated with a situation where in order to get rid of a dishonest inefficient or an inconvenient employee who is ruining the business, expenses are incurred by a firm which it can claim as revenue expenditure. A hard working fool or a scheming and unreliable person who are employed can be great potential hazards to the success of a business and therefore, if expenditure is required to be incurred to get rid of such employee in the interest of business, that can be treated as a revenue expenditure, but, the authorities which lay down that proposition cannot assist the assessee firm in the present case where the payments made towards the rights of the outgoing partners stand entirely on a different footing. The contentions raised on behalf of the assessee cannot therefore be accepted.

Under the above circumstances, we hold that the Tribunal was not right in law on the facts and in the circumstances of the case in coming to the conclusion that the sum of Rs. 2,50,348/- paid by the assessee to its retiring partners was an allowable expenditure under Section 37 of the Income Tax Act, 1961. The question referred to us is therefore, answered in the negative in

favour of the Revenue and against the assessee. The reference stands disposed of accordingly with no order as to costs.

(R.K.Abichandani,J.)

Per Rajesh Balia,J.

I agree that the question referred to us is to be answered in the negative in favour of the Revenue and against the assessee. I would like to add that it looks incongruous to say when existing partners amongst themselves decide to sever relationship between themselves in its entirety or between one or more amongst themselves, any amount paid as a result of such severance by the persons who decide to retain the assets and good-will of the firm alongwith the right to use the firm name and agrees to pay a lumpsum amount to the person or persons severing such relationship of partnership instead of sharing the assets can in the very nature of things, invite questions of the nature urged by the assessee. One has to bear in mind that tax on an income is a specie of the direct taxation which reaches the person who owns or receives the income as distinguished from indirect taxes where it reaches a thing or article or an activity, like an excise duty is a charge on the activity of manufacture, a sales tax is a tax on the event of sale, a tax on the property levied by the State is a tax on the property itself, but on the other hand a wealth tax or an income tax is a tax on the person who owns the wealth or who earns the income. If keeping this distinction in mind one were to examine the contention of the learned Counsel for the assessee that the amount in question was paid by the firm to its outgoing partner to save it from ruination and save the firm from the prospective losses be treated as an expenditure incurred by the firm wholly and exclusively for the purpose of its business so as to fall in the allowable deduction under Section 37 of the Act is founded on the premise that firm as an entity of business and its income is subject to deductions of all outgoings which may be necessary for the business irrespective of its ownership. Notwithstanding the fact that firm has been treated to be a separate entity for the purposes of taxation independent of its partners unlike its status under the general law cannot detract from the fact that this fiction which has been created for the purpose of Income Tax cannot be carried beyond the purposes of income tax so as to govern the rights inter-se between the partners and the consequences of severance of their relationship with each other. In this connection it is also to be noticed that right of a

partner on termination of existing relationship of a partnership with others whether as a result of such severance firm stands dissolved or not are in no way different. It has not been disputed and cannot be disputed that partners are the joint owners of the firm and each partner has existing right of ownership through out the continuance of its status as a partner of the firm in all its assets. On severance of such relationship by other partners what a partner is really entitled to and the nature of such entitlement is that he gets in lieu of his existing right in the firm which may constitute of a bundle of thing. Ordinarily where on such severance a division takes place every asset is required to be partitioned and share in each asset is required to be allotted to each partner according to his or her share. But the fact that by agreement some of the partners decide to retain the unity of assets by valuing the assets and offering such share of value of assets to outgoing persons only, in lieu of the share in each asset of the firm and decides to pay a lumpsum, does not detract from the fact that the lumpsum also is a part of the payment of his ownership right in the firms' assets tangible or intangible and such payments are not in any sense convey transfer of assets by the firm to the retiring or erstwhile partners. As a matter of fact on delivery of assets or payment of such value in lieu of assets no expense in ordinary sense is incurred by the firm. The assets of the firm are reduced to the extent of the interest of the outgoing partners in the case of reconstitution or in the case of dissolution, it amounts to disbursement amongst all partners. Speaking as of law it cannot be said that any amount that is paid to an outgoing partner on his retirement can have any colour other than as a result of settlement of account. How and what motivated the partners inter-se to arrive at a particular sum has no relevant bearing on the question of the nature of the payments made to the outgoing partner of change its colour from return of his share in the assets of the firm to the expenses of the firm for saving it from ruination.

The Tribunal in our opinion has clearly fallen in error in finding the motive and the reason for agreeing by some of the partners of the assessee firm to pay a certain sum to outgoing partners to continue to remain the owner of the business as such and on that premises to arrive at determination of question about the nature of payment. It may be pertinent to notice what has been severed is the relationship between the erstwhile five partners who constituted the firm before its existence in the present form. Severance of relationship cannot be

with the partner and the firm, but can only be between partners and partners. That is also reflected in the deed of retirement which in unequivocal term says that `in consideration of the full discharge of their rights, title and interest and good-will of the said partnership and in full satisfaction of all their claims in respect of the amounts contributed by the said retiring partners towards the capital of the said partnership and in full satisfaction of all sums of money due to them in respect of their current and/or loan or advance account the sums specified were to be paid to the retiring partners'.

What weighed with the continuing partners as per the retirement deed to agree to pay the specified sum to the outgoing partners so as to settle the accounts, without having recourse to adjudication, by mutual agreement is of little relevance to determine the nature of payment made to the partners as a result of this settlement. Therefore, the finding of the Tribunals about the motive which prompted the remaining continuing partners for agreeing to pay certain amounts, even if were to be accepted, cannot alter the nature of payment vis-a-vis the parties to the settlement from the one being payment in lieu of share of the outgoing partners in the firm by agreeing to severe relationship with the continuing partners. The firm, as an entity, is to be reconstituted, thereafter. However, it cannot be said in any terms that the firm as an entity which came into existence as a result of reconstitution over party to settlement arrived at between the partners of the previously constituted firm. As a matter of fact by the continuing partners agreeing to pay a lumpsum amount instead of actually taking the accounts or sharing the assets, has affected the extinguishment of proprietorship rights of the outgoing partners in the business of the firm as it was constituted before such retirement. Reconstituted firm had come in existence only thereafter. Merely because it is deemed to be continued existence of the firm for the purpose of continuity in assessment proceedings does not affect aforesaid consequence.

The matter can be looked yet from another angle. Assuming that assessee firm and the partners could be treated distinct for the purposes of transaction in question, the settlement of amount to be paid to the outgoing partners has taken place between the pre-existing firm and the existing partners then. There was no agreement or settlement between the reconstituted firm and the retiring partners for severance of the relationship. The reconstituted firm could come into existence only on the breaking up of the relationship

anterior to its existence and any amount which has been agreed to be paid to the outgoing partners between the existing firm and its partners cannot be considered to be expenses made by the reconstituted firm for severing the trade relationship. Therefore, notwithstanding the finding of the Tribunal that motive of the continuing partners was to get rid of the retiring partners, on the plea of the assessee himself it cannot be attributed to the firm as a separate and independent entity from its partners. It was a motive of some of joint owners. At the best in that event it could be said to be the payment made by the reconstituted firm on behalf of two of its partners of their agreed liability to make payment to the outgoing partners.

Reference in this connection be made to the following observations made by P.N.Bhagwati, Chief Justice, as he then was, in the case of Commissioner of Income Tax, Gujarat Vs. Mohanbhai Pamabhai, reported in 191 ITR 393.

"The interest of a partner in a partnership is not interest in any specific item of the partnership property. It is a right to obtain his share of profits from time to time during the subsistence of the partnership and on dissolution of the partnership or on his retirement from the partnership to get the value of his share in the net partnership assets which remain after satisfying the debts and liabilities of the partnership. When, therefore, a partner retires from a partnership and the amount of his share in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts on the footing of notional sale of the partnership assets and given to him, what he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners. His share in the partnership is worked out by taking accounts in the manner prescribed by the relevant provisions of the partnership law and it is this namely, his share in the partnership which he receives in terms of money. There is in this transaction no element of transfer of interest in the partnership assets by the retiring partner to the continuing partners.

The transfer of a capital asset in order to attract capital gains tax must be one as a

> result of which consideration is received by the assessee or accrues to the assessee. When a partner retires from a partnership what he receives is his share in the partnership which is worked out and realised and does not represent consideration received by him as a result of the extinguishment of his interest in the partnership assets."

The decision of CIT Vs Mohanbhai Pamabhai (supra) was affirmed by the apex Court in 165 ITR 166.

On the aforesaid settled legal position that what a firm pays and retiring partner gets on severence of his relationship is right of retiring partner in the share of profits and assets of the firm, in other words it is seperation of joint interests; nothing more nothing less, it is not possible to accept the assessee's contention.

(Rajesh Balia,J.)